Audit (Report Issue Date): Report to Management for the Year Ended 06/30/10 (11/17/10)

Observation 1: Recognition of Multi-year Contract Expenses

Division responsible: Fiscal Services Division

Observation:

During the fiscal year 2009/2010, CalPERS recorded certain expenses in the general ledger based on the encumbrance of multi-year contract amounts, which resulted in the recognition of expenses that had not yet been incurred. Expenses should be recorded in the fiscal year in which the related goods are received or services are rendered, regardless of the timing of contract authorization, in accordance with generally accepted accounting principles (GAAP). As of June 30, 2010, CalPERS' personnel analyzed expenses greater than \$100,000, by budget line item; expenses that had not yet been incurred were manually reversed out of the general ledger. While the current methodology assures that the financial statements fairly present, in all material respects, multi-year contract expenses, the process results in the following deficiencies:

- a. There is a risk that expenses less than \$100,000, by budget line item, are not recorded in the proper fiscal year in accordance with GAAP.
- b. The process is inefficient as personnel were required to investigate the recorded multi-year contract expense amounts and manually correct certain amounts that were improperly recognized during the fiscal year.
- c. Expenses reported in the Statement of Changes in Fiduciary Net Assets and supplemental Administrative Expenses Schedule had to be corrected for financial reporting purposes.

CalPERS should implement a process to ensure that multi-year contract expenses are reported in the proper period. Multi-year contract expenses should be recorded in the general ledger as the related goods are received or services are rendered.

Management's Response:

OPEN. Fiscal Services has recorded adjustments to reflect the accurate amount of multi-year contract expenses and requested closure sign-off from the Steering Committee. Fiscal Services will obtain Macias, Gini & O'Connell's approval on the process of multi-year contract encumbrances during the year-end closing.

Observation 2: Executive Review of Draft Financial Statements

Division responsible: Fiscal Services Division

Observation:

There is currently no process in place to ensure that all CalPERS executives have an opportunity to review the draft financial statements prior to the Finance Committee's approval of the financial statements. Representatives from each of CalPERS' divisions and offices should have an opportunity to review the draft financial statements to ensure proper reporting and disclosure of CalPERS' unique activities and services.

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We strongly encourage the Fiscal Services Division to distribute the draft financial statements to the appropriate executive personnel for review prior the Finance Committee's approval of the financial statements. We further recommend that Fiscal Services develop a process to review and respond to the comments and suggestions made by executive personnel to ensure that CalPERS' financial statements offer readers the most thorough and transparent view of CalPERS' financial activities and transactions.

Management's Response:

OPEN. Fiscal Services has sent an e-mail to the Financial Reporting Committee members requesting the name of staff who are to receive the executive review copy, scheduled for distribution on October 7th. Fiscal Services staff also discussed executive review process with the Chief Financial Officer and concluded that the executive review of the financial section of the CAFR would involve the Chief Financial Officer, Chief Investment Officer, and Chief Counsel.

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Observation 2: CERBTF Actuarial Valuations

Division responsible: Audit Services

Observation:

Employers participating in the CERBTF engage third-party actuaries to perform other postemployment benefits (OPEB) valuations in accordance with the CalPERS *OPEB* Assumption Model. CalPERS actuaries review each valuation for compliance with the CalPERS OPEB Assumption Model; however, current procedures do not include an independent review of the underlying participant data used by the third-party actuaries. Errors in member data may distort valuation results and lead to improper determinations of actuarial accrued liabilities and annual required contributions.

We recommend that the Office of Audit Services perform risk-based, periodic tests of participant data used by the third-party actuaries. The tests should be designed to determine that participant data used in the actuarial valuations is consistent with the participating employers' official records.

Current Status:

OPEN. Office of Audit Services completed the evaluation and selected a sample of public agencies for risk-based periodic testing. As part of a public agency review, the Office of Audit Services completed the test of participant data used in OPEB valuations provided by the employers who participate in the CERBT. The risk-based participant data review is part of a public agency report to be issued as of December 31, 2011.

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Observation 4: Real Estate Appraisals

Division responsible: Investment Office

Observation:

Properties held in separate account real estate partnerships are valued based on third-party appraisals directed by CalPERS. Appraised values are adjusted by the general partner to reflect changes in fair value between the appraisal date and the end of CalPERS' financial reporting period. CalPERS' real estate Performance Monitoring Unit (PMU) is responsible for ensuring appraised property values are properly recorded by the partnerships in accordance with the CalPERS' Investment Policy for Real Estate Accounting. During our testing of real estate partnership investments, we noted the following:

- The PMU faces significant challenges in performing the task of verifying that appraised values are being properly reflected in the partnerships' financial statements in a timely manner as there were approximately 1,600 individual properties appraised in fiscal year 2008-09 and only one staff was assigned to perform this function.
- Certain general partners report to CalPERS at the aggregate or fund level rather than the individual property level. In some instances, it was difficult to verify that the appraised values were reflected by the partnerships as property-level financial information is not provided by all general partners.
- Appraisals are completed throughout the fiscal year; however there is no process in place to evaluate the changes in fair value from the appraisal date to CalPERS' fiscal year-end.

CalPERS should enhance the current processes by employing the following recommendations:

- 1. Assign the appropriate number of personnel to verify that appraised property values are recorded by the partnerships.
- 2. Require separate account general partners to provide financial information at the underlying property level to facilitate the appraisal verification process.
- 3. For separate account real estate partnerships that were not appraised as of CalPERS' fiscal year-end, review the partnerships' June 30 financial information to ensure significant changes in fair value are properly reflected in the partnerships' June 30 financial statements.

Current Status:

OPEN. Target completion date is June 30, 2012.

- 1. RESOLVED. Pending final verification by Macias, Gini & O'Connell.
- 2. OPEN.
 - 2a. Although some existing Real Estate General Partners may have the ability to report at the property level, not all partners are contractually required to do so. Property level data is used for informational purposes only, and there is

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limited value-add in requiring the partners who are not already providing property level financials to provide this information.

Per discussion with MGO, for those Partnerships that provide property level financial information, MGO will review property levels during the year-end audit work.

- 2b. At the time a Real Estate Partnership is established in the AREIS system, the Real Estate Unit ensures CalPERS ownership percentage information for the Partnership is entered into AREIS. The PARO Unit will input the information in AREIS and will work with the Portfolio Manager in CalPERS REU to verify the appropriate effective ownership percentage.
- 2c. The Real Estate Unit will periodically review and update in the AREIS system CalPERS ownership interest in each active Partnership. The PARO Unit will work with the Portfolio Manager overseeing the fund to ensure the partnership ownership percentage is captured in the AREIS system.
- 3. OPEN. The Performance Monitoring Unit will develop a process for reviewing partnerships June 30 financial information to ensure significant changes in fair value are properly reflected.

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Observation 13: Password Requirement Non-Compliance Division responsible: Information Technology Services Branch

Observation:

We found that password requirements used to access the mainframe applications, RIBS and CRS, currently do not fully adhere to CalPERS' Information Security Identity Authentication Practice certain key areas. We recommend CalPERS' mainframe administrator update the Resource Access Control Facility (RACF) security settings to ensure that the settings comply with the Information Security Identity Authentication Practice. The Information Security Office should conduct periodic monitoring to ensure compliance.

Current Status:

OPEN. The recommendation is in the process of being implemented. With the development and implementation of PSR, it was decided that no further updates to the current legacy applications would take place. As a result, the password configuration requirements were not updated to be in compliance with the information Security Identification Practice. This recommendation, however, will be addressed with the PSR system implementation and will replace the mainframe application, RIBS and CRS. Target completion date: June 30, 2012.

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Observation 15.4: Shared User Accounts

Division responsible: Information Technology Services Branch

Observation:

Shared accounts are being used by the database administrators when accessing the Oracle database or the VSAM file environment. The use of these shared accounts creates a situation wherein actions taken within the database system cannot be tracked back to a specific individual. Inadvertent or malicious activity may not be able to be positively associated with a specific individual essentially eliminating an effective audit trail.

CalPERS Information Technology Services Branch should evaluate the use of shared accounts and discontinue their use where it has been determined there is a risk to the database. Database administrator accounts with schema owner access should be controlled with access granted sparingly and only after proper approval has been granted.

Current Status:

RESOLVED. Pending final verification by Macias, Gini & O'Connell. This prior year recommendation has been implemented and the Enterprise Privacy & Protection Office is awaiting word from MGO in regard to closing out this finding. The User Access Team has reviewed the shared accounts with access to the VSAM files and the Oracle Schema Owner accounts and has received the necessary approvals as required by CalPERS policy. The Guardium SQL appliance that monitors database access and activity was implemented in late September 2011as part of the PSR Project.

Observation 15.5: Schema Owner Access

Division responsible: Information Security Office

Observation:

Database administrator with accounts to the Oracle database or the VSAM environments may potentially have the capability to alter member information affecting benefits payments. Tests have not been conducted to determine if the database systems have sufficient logging triggers or oversight such as file balancing or reconciliations to verify if unauthorized changes can be detected.

The CalPERS Information Security Office should conduct testing to determine if persons with schema owner access to the Oracle database or to the VSAM files can make changes to the database that would affect member benefits without detection.

Current Status:

RESOLVED. Pending final verification by Macias, Gini & O'Connell. In concert with the PSR implementation in September, the PSR team implemented Guardium. Guardium provides CalPERS the ability to detect DBA (i.e. Persons with schema owner access) changes directly in the database environments.